QUESTION PRESENTED FOR REVIEW

In computing the credit under section 902 of the Internal Revenue Code[1] for foreign taxes deemed paid by a domestic corporation with respect to dividends received from its foreign subsidiary, should the accumulated profits of the foreign subsidiary be allocated to various years, for purposes of determining the source of dividends paid, (a) as determined by the foreign government in imposing its tax or (b) in accordance with the rules that would have been applied by the United States in determining the taxable income of a domestic corporation?

The Goodyear Tire & Rubber Company, the Respondent here, has restated the question to make it plain that the question presented involves associating the profit which is the source of the dividend with the foreign tax imposed on that profit for which the credit is claimed. The question presented as stated by the Government in its brief is ambiguous in this regard and does not clearly reflect the issue defined by the Stipulation of Facts and decided by the Court of Appeals.

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[1]Unless otherwise noted, citations to the Internal Revenue Code and "section" references herein are to the Internal Revenue Code of 1954 as in effect in 1970 and 1971 or to the sections thereof, as the case may be.

RULE 28.1 LIST OF AFFILIATES

The Rule 28.1 List of Affiliates previously submitted by The Goodyear Tire & Rubber Company and Affiliates on pages (ii) and (iii) of its Brief in Opposition to the Petition for a Writ of Certiorari in this case currently is accurate.

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No. 88-1474

IN THE

Supreme Court of the United States

October Term, 1988

UNITED STATES OF AMERICA, *Petitioner*,

v.

THE GOODYEAR TIRE & RUBBER COMPANY AND AFFILIATES, *Respondent*.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

BRIEF FOR THE RESPONDENT

STATUTORY AND REGULATORY PROVISIONS INVOLVED

This case involves sections 901 and 902 of the Internal Revenue Code of 1954 (26 U.S.C. §§ 901 and 902) and section 1.902-3(c)(1) and (4) of the Treasury Regulations (26 C.F.R. § 1.902-3(c)(1) and (4)), as in effect for 1970 and 1971. Section 1.902-3(c)(4) of the Treasury Regulations is set forth below in pertinent part in an appendix to this brief. Resp. App., *infra* pp. A1-A2. Sections 901 and 902 of the Internal Revenue Code of 1954 and Section 1.902-3(c)(1) of the Treasury Regulations are set forth in pertinent part in the Appendix to Petitioner's Brief. Pet. App. at 1a-4a.

STATEMENT OF THE CASE

1. **Procedural.** In its federal income tax returns for 1970 and 1971, the Respondent, The Goodyear Tire & Rubber Company and Affiliates ("Goodyear"), claimed foreign tax credits for taxes deemed paid with respect to dividends received from its wholly-owned British subsidiary, The Goodyear Tyre & Rubber Company (Great Britain) Limited ("Goodyear England"). The Petitioner, The United States of America (the "Government"), disallowed the credits claimed, assessing additional taxes and interest for those years.

Goodyear paid the assessments and filed claims for refund. When the refunds were denied, Goodyear sued in the United States Claims Court. *Goodyear Tire & Rubber Company and Affiliates v. United States of America*, No. 510-85 T. Goodyear and the Government submitted cross motions for summary judgment in the Claims Court proceeding (Joint Appendix filed with the Federal Circuit at 32, 36) and the Claims Court granted the Government's motion and denied Goodyear's motion. 14 Cl. Ct. 23; Cert. App. at 9a-28a.[2] On appeal by Goodyear, the United States Court of Appeals for the Federal Circuit unanimously reversed the Claims Court. 856 F.2d 170; Cert. App. at 1a-8a, 29a.

Thereafter the Court of Appeals unanimously denied the Government's motion for rehearing, and the entire Court of Appeals, with one dissent, declined the Government's suggestion for rehearing *en banc*. Cert. App. at 30a-31a. This Court granted a writ of certiorari to the Court of Appeals on May 1, 1989. J.A. at 62.

2. **Substantive.** The relevant facts and the issue in this case have been stipulated (J.A. 19-29) or appear in an affidavit filed with Goodyear's Motion for Summary

[2] "Cert. App." refers to the Appendices to the Petition for a Writ of Certiorari; "J.A." refers to the Joint Appendix filed with this Court; "Pet. App." refers to the appendix to the Government's Brief on the Merits; and "Resp. App." refers to the appendix to this brief.

Judgment. Joint Appendix filed with the Federal Circuit at 34-35.

In each year of the years 1968 through 1971, Goodyear England had substantial income (before net operating loss carryback deductions) and paid dividends to Goodyear. A small part of its income was derived from Ireland and the rest from its operations in Great Britain. Stip. ¶ 6, J.A. at 11; Ex. M-P, J.A. at 32-49; Stip. ¶ 16, J.A. at 25.

In 1972 and 1973 Goodyear England incurred losses. Stip. ¶ 6, J.A. at 21. The losses were generated, in principal part, by the application of two provisions of British tax law that differ from U.S. law. First, with respect to purchases of new fixed assets during the year, the British depreciation provisions allowed shorter useful lives in 1971 and thereafter than would have been allowed by U.S. law to a U.S. taxpayer. Stip. ¶ 10, Ex. B and C, Joint Appendix filed with the Federal Circuit at 43, 56-58, 60-61. Second, in computing the 1973 closing inventory, British law permitted a British taxpayer to reduce its inventory by the increase in the inventory's value less 10% of "trading profit" for the year. Stip. ¶ 9, Ex. A, Joint Appendix filed with the Federal Circuit at 42-43, 51-55.

The treatment of the 1973 loss and the adjustments to Goodyear England's 1970, 1971, and 1973 income as a result of the loss and its carryback gave rise to the present case.[3] The 1973 loss (as determined to the satisfaction of the British tax authorities) was applied by

[3] There is no dispute as to the amount of the 1972 loss. That loss, computed in accordance with the British tax law, was carried back to 1971 and applied to reduce Goodyear England's accumulated profits for 1971. The 1972 loss also reduced the British taxes paid for 1971 because the amount of the 1972 loss was known by the time the 1971 tax was paid. The 1971 dividend was thus previously considered to have been paid out of the accumulated profits for 1971 as reduced by the 1972 loss carryback and by the net taxes paid. The Commissioner of Internal Revenue raised no issue as to the existence or effect of the 1972 loss, and the figures shown in Exhibits I and J to the Stipulation (J.A. at 30-31), which reflect deduction of the 197 net operating loss carryback, are not in dispute.

Goodyear England (pursuant to British law) as a net operating loss carryback deduction first to 1971, where its deduction more than eliminated all remaining 1971 profit of that company. The remainder of the 1973 loss was carried back, again pursuant to British law, to 1970, where its deduction eliminated a large part of Goodyear's profit for that year. Stip. ¶ 14, J.A. at 24. The elimination of Goodyear England's 1971 profit and the reduction of its 1970 profit resulted in the refund to Goodyear England in 1975 of an amount equal to all of its 1971 British tax and a portion of its 1970 British tax. Stip. ¶ 19, J.A. at 26.

Under section 902 of the Code, Goodyear was entitled to a credit for foreign taxes "deemed paid" by it with respect to the dividends it received from Goodyear England. In effect section 902 provides that the tax "deemed paid" by the domestic parent is the tax imposed by the foreign country on the profits of the foreign subsidiary *out of which* the dividend was paid. Goodyear contended that "accumulated profits" refers to the British tax base, as determined by the British taxing authorities, so that, after taking into account the net operating loss carrybacks from 1972 and 1973, the 1970 and 1971 dividends were paid out of accumulated profits for 1968, 1969 and 1970, as set out in Exhibit I (J.A. at 30), and claimed credit for British taxes paid in these years. Stip ¶ 18, J.A. at 26.

The Government contended that "accumulated profits" meant taxable income computed as if Goodyear England had been a U.S. corporation and denied the existence of the 1973 loss and its carryback.

The parties have stipulated that if Goodyear's contention is correct, the redetermination of the foreign tax credits with respect to the dividends paid in 1970 and 1971 is to be made as set out in Exhibit I to the Stipulation (J.A. at 30), while if the Government's contention is correct, the redetermination is to be made as set out in Exhibit J to the Stipulation. J.A. at 31.

NEW POSITION BEING TAKEN BY THE GOVERNMENT FOR THE FIRST TIME IN THIS COURT

A. The Government, in contending that "accumulated profits" means "earnings and profits," has departed from the Stipulation of Facts in this case.

The Stipulation provides in paragraph 7 that:

> . . . the Commissioner determined that the *income before taxes* of Goodyear England computed under United States *income tax* concepts was as follows for the years indicated [reciting the figures used in Joint Exhibit J]. [Emphasis supplied]

Paragraph 24 of the Stipulation provides that:

> Defendant's position with respect to the computation of plaintiff's foreign tax deemed paid relating to the dividends received from Goodyear England for the years 1970 and 1971 as determined under United States tax concepts is set forth in Joint Exhibit J.

Paragraphs 6 and 23 correspondingly specify that Goodyear's position is set out in Joint Exhibit I and is based on the income of Goodyear England "as accepted by the British taxing authorities."

The issue was thus drawn by the Stipulation. The Government now appears to be trying to shift the case to an entirely new issue by claiming that the profits are to be determined on the basis neither of the amounts set forth in Exhibit I as Goodyear contends, nor in Exhibit J as the Government has always heretofore contended, but of what the Commissioner of Internal Revenue might determine to be the "earnings and profits" of Goodyear England, which are not even mentioned in the Stipulation.

Surely the Government cannot now take a position in this Court on which no evidence is presented in the record and that is contrary to the Stipulation on which the case was tried and decided in the Courts below. *See, e.g., General Utilities & Operating Co. v. Helvering*, 296

U.S. 200 (1935); *New York, Lake Erie & W. R.R. Co. v. Estill*, 147 U.S. 591 (1893).

B. By contending that the formula for determining the foreign tax deemed paid is to be applied to the aggregate of past taxes and past income of Goodyear England, the Government is taking a new position which, if correct, must necessarily result in the allowance of most of Goodyear's refund claim.

Another new and surprising element in the Government's brief is the assumption that "accumulated profits" as the phrase is used in section 902 is used in an aggregate sense, including the profits of past years. On page 13 of the Government's brief we find the statement that "accumulated profits" is to be identified with "the pool of potential dividends determined under U.S. law." On page 16 "accumulated profits" is identified as "an ordinary accounting term that includes earnings of prior years as well as current earnings." Similar statements appear elsewhere in the Government's brief on pages 10, 11, 12, 13, 14, 16, 17, 18, and 20. While some reference is made to "sourcing" it does not appear to change the Government's position that "accumulated profits" means aggregate profits for all years.

The taxes, too, are taken by the Government's brief to be on an aggregate basis. Thus in referring to the Revenue Act of 1921 on page 16 of its brief the Government said that Congress "needed to describe the total earnings of the foreign corporation, past and current, which are the source from which dividends can be declared, and then to allow a credit for the *foreign taxes already paid* upon the distributed portion of those earnings." [Emphasis supplied.] Again on page 17 the statutory formula is paraphrased to say in effect that the credit is the proportion of the "foreign taxes paid upon the pool of profits." The same ratio is repeated on pages 19 and 20.

The formula that the Government now asserts actually is the formula of section 902 *as amended prospectively by the Tax Reform Act of 1986*. Pub. L. No. 99-514, § 1202(a), 100 Stat. 2528. If the Act of 1986 applied here there probably would be no issue large enough to litigate. The aggregate of past taxes includes the very taxes (for 1968 through 1970) which Goodyear claims as credits here.

Unfortunately this formula is not the formula that the Internal Revenue Service applied to Goodyear, and in fact a similar formula was rejected by the Tax Court 45 years ago. *General Foods Corp. v. Commissioner*, 4 T.C. 209 (1944), *acq.* 1946 C.B. 2.

While a result in accord with this argument by the Government would undoubtedly result in recovery by Goodyear of most of its refund claim, the audit problems in calculating it are extremely complex, and the problems confronted by U.S. companies generally having foreign subsidiaries, which would all need to be reaudited for all open years, would make the reversal of the *General Foods* case at this late date most unfortunate.

Under all the circumstances it seems advisable for Goodyear to argue here in favor of section 902 as in effect for the years from 1970 through 1973, rather than in favor of the Tax Reform Act of 1986.

SUMMARY OF ARGUMENT OF GOODYEAR

In order to avoid double taxation of the profits of a foreign subsidiary of a U.S. corporation by both the foreign country in which it is located and by the United States (upon the payment of taxable dividends by the subsidiary), section 901 grants a credit against U.S. tax for the foreign taxes deemed paid by the U.S. corporation. Section 902 provides that the amount of foreign taxes "deemed paid" by the U.S. parent is to be in the same ratio to the foreign taxes paid by the foreign subsidiary as the dividend bears to the "accumulated profits" of the foreign subsidiary in excess of the foreign taxes. Case law provides that the determination of the

ratio is to be made on a year by year basis. Thus each dividend must be "sourced" or attributed to a particular year's accumulated profits so that the ratio of the dividend out of accumulated profits of that year to total accumulated profits of that year can be determined and applied to that year's foreign tax to determine the appropriate credit.

It is the contention of Goodyear that the statutory language, the fulfillment of the statutory purpose of avoiding double taxation and the relevant authorities require that the *sourcing* of the dividend out of each year's accumulated profits be made by reference to the foreign corporation's gains, profits and income as determined by the foreign country in which the subsidiary is taxed. This method results in a *matching* of each year's foreign tax and that year's accumulated profits on which the foreign tax was imposed and out of which the dividend is treated as paid under the sourcing principle.

The Government's argument that the accumulated profits are to be computed and sourced like the taxable income of a U.S. taxpayer can, and does, result in a mismatching of annual "accumulated profits" and the actual foreign tax, with double taxation as an inescapable consequence. Further, the Government's position rests solely on an asserted administrative practice which is *not* supported by its own Regulations or a consistent rulings policy. For these reasons, the decision of the Court of Appeals for the Federal Circuit should be affirmed.

ARGUMENT

I. When the British tax authorities determined (1) that Goodyear England had a loss in 1973 and (2) that the loss should be carried back as a deduction to 1971 and 1970, those determinations should have been reflected in the recomputation of the foreign tax deemed paid by Goodyear with respect to its 1970 and 1971 dividends received from Goodyear England.

A. Introduction.

At the time of the Claims Court and Court of Appeals proceedings, the parties here were in agreement as to the general structure of the statutory and Treaty arrangements for computing the tax appropriate to a dividend. They agreed on the formula to be used in determining the tax appropriate to the dividend. They agreed on the accepted rule that a dividend must be "sourced" in appropriate cases to earlier tax years of the foreign corporation to determine the amount of foreign tax paid on the profit out of which the dividend was paid. They agreed that when a foreign tax is refunded, the "tax deemed paid" on the dividend must be completely recalculated taking into account all appropriate adjustments. They disagreed, however, on whether, in sourcing the dividend to earlier years, the U.S. tax authorities must find the profit in the years where the foreign tax authorities found it and taxed it, or whether they may reconstruct the income of the foreign corporation as if it had been a U.S. corporation and U.S. tax rules had applied.

It is important to understand that for the U.S. tax authorities to recognize and apply the determinations made by the British does not mean that the U.S. Internal Revenue Service must conduct an audit of the British corporation, attempting to apply British law. On the contrary it means that the U.S. authorities should recognize the amount of British profit, and the year in which it was taxed, as the British tax authorities determined it, and should no more attempt to revise that determination than they would attempt to revise the timing and

amount of the British tax. The statement by the Government of the Question Presented for Review is a little misleading with respect to this point.

B. The structure of the foreign tax credit.

The solution to this case may seem more obvious once the system of calculating the "indirect" or "deemed paid" credit is clearly understood. For that reason a large part of this brief will be devoted to an attempt to explain that system as clearly and simply as its complicated nature permits. In particular five concepts must be grasped:

(1) The resemblances and differences between the "direct" and "indirect" foreign tax credits.

(2) The basic formula for computing the "tax deemed paid."

(3) The concept of "grossing up."

(4) The concept of "sourcing."

(5) The overall limit on the amount of foreign tax credit allowable.

1. Definitions of terms. At this point it is necessary to define several phrases used in the Code:

a. "Income," "gross income," "net income," "taxable income": These are all terms used in computing the income of a U.S. taxpayer subject to U.S. tax. The dividends Goodyear received in 1970 and 1971 from Goodyear England were includible in its U.S. parent's "gross income" for those years.

b. "Gains, profits, or income," "profits or income": These terms are used generally in the foreign tax credit provisions of the Code (*e.g.*, section 902(c)) to refer to the amount with respect to which a foreign country imposes its "income, war profits or excess profit taxes" on a foreign corporation. They are not used anywhere in the Code in referring to income subject to U.S. tax. The Claims Court (the trial court here) and the Court of Appeals *both agreed* that this term referred to the *foreign* taxable income. Cert. App. at 6a, 26a.

c. "Earnings and profits": This term is used in the Code (*e.g.*, section 312) to refer to something analogous to "surplus" under the corporation laws. While the Code may refer to the "earnings and profits" of the current year, the term more often refers to the "earnings and profits" on hand from all years. The term is important chiefly in determining whether a corporate distribution received by a shareholder is ordinary income or a distribution of capital. It is not mentioned in the Stipulation.

d. "Accumulated earnings," "accumulated earnings and profits": These are terms defined in connection with the tax imposed by Code sections 531 *et seq.* on income accumulated by a corporation beyond the needs of its business, but have nothing to do with the foreign tax credit.

e. "Accumulated profits": This term is applied exclusively to foreign corporations in connection with the "deemed paid credit" under section 902 with which we are concerned here. Indeed it is used in the Code *only* in section 902 and related sections. In contrast to "earnings and profits" it does not refer to an accumulation from previous years; notwithstanding its peculiar label, it refers to each year separately and means the "gains, profits or income" for that year without reduction for the foreign taxes imposed on or with respect to it. Section 902(c)(1).

2. While the indirect tax credit is intended to carry out the same general purpose (of avoiding double taxation) as the direct tax credit, it differs in important respects which relate to the issue here. Section 901 of the Code allows to U.S. taxpayers a credit (the "direct" credit) against U.S. tax for income taxes paid by U.S. taxpayers to a foreign country. It also allows to U.S. corporate taxpayers a similar credit (the "indirect" credit) for taxes paid by a foreign corporation (and "deemed paid" by the U.S. taxpayer) as provided in section 902. Section 902 applies where the U.S. taxpayer

receives dividends from a foreign corporation out of income of the foreign corporation already taxed in the foreign country. In order to understand this case, it is necessary to understand how both credits are determined.

a. The direct credit. If Goodyear had operated a branch in England, rather than a separate subsidiary corporation, it would have had to file tax returns in its own name in Great Britain as well as in the United States. If it had earned $1,000 in Britain in any of the years here involved it would have paid a tax of $400 (40%) to Britain.[4] It could then, if it so elected, report the entire $1,000 in U.S. income, taking no deduction for the foreign tax, but crediting the British tax against the U.S. tax. The U.S. rate being 48%, the gross U.S. tax of $480 would be reduced to $80 by the credit of $400. Note that out of $1,000 of earnings in Britain, 40% has gone to Britain and 8% to the U.S. *The relationship of these rates is the touchstone in Goodyear's argument that consistent results should be reached under section* 902.

Even if the U.S. concluded that the foreign income should be in a different amount or should fall in a different year, the timing and amount of the *direct* credit would not be affected. Subject to section 904 (which limits the amount of both the direct and the indirect credits to an amount equivalent to the U.S. rate of tax), *all the foreign tax paid arising from a branch operation is recovered as a direct credit in the year to which it relates.* This means that if Goodyear had operated in England through a branch rather than through a subsidiary, it would already have received full credit in

[4] For purposes of all the examples set forth in this brief, the United States rate of taxation will be assumed to be 48% and the British rate of taxation will be assumed to be 40%, except where otherwise expressly stated. These are the actual comparative rates of taxation involved in the present case.

1968, 1969, 1970 and 1971 for the taxes at issue here and the problem in the present case could not have arisen.

b. The indirect credit. But Goodyear does not operate in England. It does have a subsidiary there, Goodyear England, which pays its own British tax on its own earnings as computed to the satisfaction of the British tax authorities. The subsidiary's U.S. parent is not concerned with the British tax until it receives a dividend from its subsidiary. When it does so it claims an "indirect credit" for the "appropriate amount" of "tax deemed paid" to Britain on the profits from which the dividend was paid.

Thus the indirect credit differs from the direct credit in two major respects:

(1) The indirect credit becomes available *only upon receipt of a dividend,* which may occur years after payment of the foreign tax.

(2) The indirect credit is allowed only for foreign taxes paid *on the profit out of which the dividend was paid.*

The issue here is how to determine the "profit out of which the dividend was paid" when we know the foreign tax paid on it. That issue does not arise with the direct credit.

3. The basic formula for computing the tax deemed paid. The United States-United Kingdom Tax Treaty is designed to prevent double taxation. Article XIII of the Treaty provided in part:

> [I]n the case of a United States corporation owning at least 10 percent of the voting power of a corporation resident in the United Kingdom, [the United States] shall allow credit for the *appropriate amount of United Kingdom tax paid by the corporation paying such dividend with respect to the profits out of which such dividend is paid, if the recipient of such dividend includes in its gross income for the purposes of United States tax the amount of such United Kingdom tax. . . .* [Convention for the Avoid-

ance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, April 16, 1945, U.S.-U.K., Art. XIII(1), as amended by Supplementary Protocol signed March 17, 1966] [Emphasis supplied]

Sections 901 and 902 of the Code apply these Treaty provisions to U.S. taxpayers. The indirect credit under the Treaty is the "appropriate amount of United Kingdom tax." The Treaty does not further define that phrase, but it is clear that the Treaty describes dividends as being paid *out of profits* and that the credit is based on the tax with respect to *those profits*.

Section 902 (as in effect in 1971, 1972, and 1973 and substantially as in effect in 1970) provided in part, as to dividends from foreign corporations other than in less-developed countries:

> (a) TREATMENT OF TAXES PAID BY FOREIGN CORPORATION. — For purposes of this subpart, a domestic corporation which owns at least 10 percent of the voting stock of a foreign corporation from which it receives dividends in any taxable year shall —
>
> (1) to the extent such dividends are paid by such foreign corporation *out of accumulated profits* . . . be deemed to have paid the same proportion of any income . . . taxes paid . . . by such foreign corporation to any foreign country . . . on or with respect to *such accumulated profits*, which the amount of such dividends . . . bears to the amount of *such accumulated profits* in excess of such . . . taxes . . . . [Emphasis supplied]

This gives us the basic formula: for any dividend received by a domestic shareholder of a foreign corporation, the tax deemed paid by the domestic shareholder is the net dividend paid by the foreign corporation divided by the "accumulated profits" of the foreign corporation after tax, and multiplied by the foreign tax paid by the foreign corporation *on those accumulated profits*. This formula may be abbreviated as TD/P, where T is the foreign tax for a year, D is the dividend paid by the foreign corporation out of the accumulated profits of that year, and P is the "accumulated profits" of the foreign corporation for that year after tax. The tax referred to in the formula is the tax *on those "accumulated profits"* and the "accumulated profits" in the denominator are the *same* "accumulated profits" after deducting the *same* tax.

4. The concept of "grossing up." The language in the Treaty requiring the U.S. parent to include in its gross income the amount of the United Kingdom tax refers to the principle called "grossing up." At this point it is appropriate to mention *American Chicle Co. v. United States*, 316 U.S. 450 (1942), not only because it is this Court's only previous consideration of the "tax deemed paid" credit, but also because it led to the "grossing up" concept.

The problem in *American Chicle* may be explained briefly by assuming that a foreign corporation earns $1,000, pays a 40% tax of $400, and in the same year distributes the remaining $600 as a dividend to a U.S. corporation, whose tax rate is 48%. The U.S. corporation claims a credit of $400 against the U.S. tax on the dividend. The gross U.S. tax on the $600 dividend would be $288 and the credit would exceed the U.S. tax. Something was clearly wrong. The Government argued successfully that the U.S. corporation was claiming a credit not only for the foreign tax attributable to the dividend but also for the foreign tax attributable to the funds used to pay the foreign tax. So the decision in effect reduced the credit in the example by 40% of the foreign tax, or $160, leaving a credit of $240. The total tax paid on the original $1,000 was now $448, $400 to the foreign government and $48 to the U.S. The apparent rate of total tax was now 44.8%.

Something was still not quite right with the formula, and the debate went on. The Treaty was en-

tered into in 1946, and the Code was amended by the Revenue Act of 1962, Pub. L. No. 87-834, § 20(a), 76 Stat. 960, and we now have a new solution: the Treaty and Section 78 of the Code require that the foreign tax deemed paid be *added to the dividend* (the "grossing up" concept). Now in the example above the U.S. shareholder reports a dividend of $1,000 ($600 distribution plus $400 tax deemed paid), a gross U.S. tax of $480 and a net U.S. tax (after allowing the foreign tax credit of $400) of $80. The total tax paid out of $1,000 of income earned is $480, or 48%, which is just what it should be, and the entire foreign tax of $400 has been recovered as a credit. Double taxation has been avoided and the net results match the branch taxes.

5. The concept of sourcing. It might be supposed that in applying the formula TD/P, P might refer to an aggregate amount of after-tax profit for all years (as indeed the term "accumulated profits" seems to suggest) and that T would represent the sum of the taxes for all years. The Government's brief makes this assumption here, and one taxpayer so argued when the quoted term was new, but the Tax Court held otherwise. *General Foods Corp. v. Commissioner*, 4 T.C. 209 (1944), *acq.* 1946 C.B. 2. The Tax Court held (and this is now well-settled) that the calculation was to be made on an annual basis; that is, the fraction TD/P was to be computed for each year, P being the after-tax profit of a given year, T the foreign tax on *that* year's profit, and D the amount of the dividend paid out of *that* year's profit, whether or not paid *in* that year. The court said:

> To properly give effect to the language of the [statute], it is necessary to relate the tax credit to the particular year or years in which the accumulated profits (from which the dividends were paid) were earned and taxed. [4 T.C. at 216]

The concept of "sourcing," *which is critical to the present case*, in effect requires segregating the foreign subsidiary's income — its "accumulated profits" before

tax — by years. It is as if each year's profit is put in one of a row of pigeonholes in an old-fashioned desk. Out of each year's profit the foreign tax on it is paid and the receipt for the corresponding foreign tax is put in the corresponding one of a parallel row of annual tax pigeonholes. To find the numbers for the formula in section 902, the dividend is first assigned to the pigeonhole for the year in which the dividend was paid. Section 902(c)(1). If there is enough profit there to cover the dividend, we simply determine the fraction D/P by dividing the dividend by the profit. This fraction is multiplied by the tax in the corresponding pigeonhole for the same year to determine the tax deemed paid.

If, on the other hand, the dividend paid exhausts the profit for the year to which it was initially assigned, the rest of the dividend takes some of the profit from the pigeonhole for the next preceding year. Thus the "tax deemed paid" will be all of the tax corresponding to the first pigeonhole and part of the tax proportionate to the profit in the pigeonhole for the previous year.

It will be readily seen that this method will ordinarily produce a fair allocation for each year. Example 1 shows the result if a $300 dividend is "sourced" to two years:

Example 1

Year	1	2
Gains, profits or income of foreign corporation	$ 600	$ 400
Foreign tax	− 240	- 160
Accumulated profits after tax	360	240
Dividend		300
TD/P	$\frac{(240 \times 60)}{360} = 40$	$\frac{(160 \times 240)}{240} = 160$
Total tax deemed paid = 40 + 160 =		+ 200
Grossed-up dividend		500
Gross U.S. tax at 48%		240
Less credit for tax deemed paid		− 200
Net U.S. tax		40

The "tax deemed paid" is 40% (the assumed foreign rate) of the "grossed-up" dividend, and the effective combined tax burden will ordinarily approximate that on a branch operation. *See supra* p. 12. The Treasury Regulation applicable to the present case illustrates the sourcing principle at Treas. Reg. § 1.902-5(e), Example (1).

Three points must be noted. First, the use of the "pigeonhole" approach of the *General Foods* case is not needed for the calculation of foreign tax credits for a *branch* operation. In a branch operation the U.S. corporation reports its foreign income every year and claims its foreign tax credit every year. With a subsidiary, the income is reported only when it is distributed, and it is then that the *General Foods* case requires that the income and taxes of the foreign corporation be allocated to the pigeonholes representing the current and past years.

The second point to be noted is that when the total dividend exceeds P, D in the formula does not represent the total amount of the dividend. It represents only the part of the total dividend which is assigned —"sourced" — to that year. Thus the computation is repeated each year with a different T, a different D, and a different P, and the results — the taxes deemed paid for each year — are added to produce the total tax deemed paid. There should be no difference of opinion between Goodyear and the Government up to this point.

Third, while tax receipts are simply assigned to the pigeonholes for the years with respect to which the taxes were assessed, the essential issue here is how best to allocate the "gains, profits and income" to the right pigeonholes so that they are paired with the foreign tax imposed on them. Goodyear contends that if the gains, profits and income assigned by the foreign taxing authority to any pigeonhole are changed to a different pigeonhole or changed in amount, the principle of sourcing is violated and distortion of the credit and

double taxation result. In Goodyear's view the Code, Treasury Regulations and decided cases support this conclusion.

The Tax Court recognized the significance of pairing the "gains, profits and income" of a foreign corporation with the tax imposed on them for purposes of the section 902 credit. In *H.H. Robertson Co. v. Commissioner*, 59 T.C. 53 (1972), *aff'd mem.*, 500 F.2d 1399 (3d Cir. 1974), the Tax Court stated:

> It is of critical importance to determine the "accumulated profits" of each year, so that they can be matched against the foreign taxes paid for *that* year, and so that when dividends are paid "out of" or "from" such "accumulated profits," a foreign tax credit may properly be computed as a portion (in accordance with the statutory formula) of the foreign taxes paid in respect of the "accumulated profits" of *that* year. [59 T.C. at 79] [Emphasis by the court]

In *Champion International Corp. v. Commissioner*, 81 T.C. 424 (1983), *acq.* 1984-2 C.B. 1, *acq. partly withdrawn* Rev. Rul. 87-72, 1987-2 C.B. 170, the Tax Court again noted that the section 902 credit must be computed in a manner that correlates the foreign tax with the profit on which that tax was paid and out of which the dividend was distributed:

> The purpose of U.S. tax principles in the context of section 902 is to establish a correlation between the foreign taxes paid on the foreign subsidiary's accumulated profits of a particular year and the dividends paid from the same year's accumulated profits. *To ignore the fact that foreign law computes the tax liability by allowing for loss carrybacks is to assure that this correlation will be lost.* [81 T.C. at 440] [Emphasis supplied]

The problem in the present case arises when the foreign government, in imposing its tax, computes the "gains, profits and income" subject to tax in a given year

as a different amount from what would have been the "taxable income" of the subsidiary if it had been a United States corporation paying United States taxes. *This is the point at issue in the present case,* as reflected in Exhibits I and J to the Stipulation, where the positions of the parties are set out in paragraphs 23 and 24. *See* J.A. at 26-27, 30-31.

6. The overall limit on the amount of foreign tax credit available. Section 904(a) of the Code provided that the credit should not exceed the same proportion of the tax against which the credit is taken (the U.S. tax) which the taxpayer's income from the foreign country bears to the taxpayer's total income. At the taxpayer's option this formula could be applied either on a country by country basis or by using *all* foreign taxes and *all* foreign income.

This limit applies both to the direct credit (as in a branch operation) and to the indirect credit (as in a subsidiary operation). The effect of it is to prevent the U.S. taxpayer from claiming credit for foreign taxes at rates of tax exceeding U.S. rates. It has no application here, but is mentioned to avoid confusion with the similar section 902 formula.

C. Revising foreign determinations of "accumulated profits" by applying U.S. rules causes distortion and double taxation.

It is not disputed that Goodyear correctly included in its gross income as dividends *all* the distributions it received from its British subsidiary. It is not asserted by the Government that Goodyear claimed as foreign tax credits more British taxes than those actually paid and not previously credited or refunded. It is not disputed that if Goodyear England had been a branch, all those British taxes would have long since been allowed as credits against U.S. tax. It is not disputed that if Goodyear wins this case it will be allowed credit for British taxes it actually paid in 1968, 1969, 1970 and 1971. Ex. I, J.A. at 30. Then what is the dispute about? Only that the Government seeks, by one means or another, to recalculate the foreign income so as to disconnect it from the foreign tax and prevent the credit. In computing P (accumulated profits after tax) in the formula TD/P for each year, the Government has argued (at least in the lower courts) that "accumulated profits" means taxable income computed under U.S. rules, as if Goodyear England had been a U.S. corporation.

To put the simplest possible case, suppose that a British subsidiary reports to the British taxing authorities under British law that it earned $1,000 in year 1, paying $400 tax, and earned nothing in year 2, although it paid a $600 dividend in year 2. Suppose further that the U.S. rules would put the $1,000 profit in year 2:

Example 2

Under British Rules:[5]

Year	1	2
Profit	$1,000	0
British tax	– 400	– 0
Accumulated profits after tax	600	0
Dividend		600

TD/P = 400 × 600/600 = 400

Under U.S. Rules:

Year	1	2
Profit	0	$1,000
British tax	– 400	– 0
Accumulated profits after tax	– 400	$1,000
Dividend		600

TD/P = 0 × 600/1000 = 0

[5] We have used "British rules" throughout this brief as a short-hand label for results that follow under section 902 from a decision to allocate the gains, profits and income where the British taxing authorities did, as set out in paragraph 6 of the Stipulation. J.A. at 11.

Computation of U.S. Tax and Credit

	British Rules	U.S. Rules
Net dividend	$ 600	$ 600
Tax deemed paid	+ 400	+ 0
Grossed-up dividend	$1,000	$ 600
Gross U.S. tax (48%)	480	288
Credit	− 400	− 0
Net U.S. tax	80	288
Total tax paid to both countries out of $1,000 earned	480	688
Effective combined rate of tax on $1,000 of foreign profit	48%	68.8%

Under the Government's theory the dividend would be treated as paid out of "profits" of year 2 so that there would be no foreign tax to claim as a credit and the U.S. tax would be $288. There was a tax in year 1 but that tax, in the Government's view, was imposed on no income and is lost forever.

Essentially double taxation occurs whenever the effective combined rate of taxation (such as 68.8% in the example) exceeds the tax either country would impose on income taxed by it alone. An effective combined rate of 48% avoids double taxation and corresponds with the total tax on a branch operation.

Example 2 presents the very essence of Goodyear's case. Since section 902 in effect provides that in the fraction TD/P as applied to each year to which the dividend is sourced —

P is the accumulated profit less the tax on *that profit,*

T is the tax on *that profit,* and

D is the dividend paid out of *that profit,*

it should be obvious that all three elements are interrelated and that to shift any one of them to a different year can create a distortion resulting in double taxation, contrary to the Treaty and section 902.

The same kind of distortion inevitably arises when, as here, there is a net operating loss. Such a loss is carried back and deducted under British law in the *first*

preceding year in which there was a profit, and then in the second; but under U.S. law it is carried back and deducted first in the third preceding year. I.R.C. § 172. Thus if U.S. rules apply in computing P, the reduction in profit is in one year but the reduction in tax is in another. Distortion is inevitable. This gives us the following example:

Example 3

Year	1	2	3	4
Profit	$1,000	$1,000	$ 1,000	−$1,000
British tax	−400	−400	−400	−0
Accumulated profits after tax	600	600	600	−$1,000
Carryback deduction allowed in preceding year under British rules:				
Reduction in profit	0	0	−1,000	
British tax refunded	0	0	+400	
Accumulated profits after tax	600	600	0	
A dividend of $300 in year 4 is considered paid out of accumulated profit of year 2				$300
Tax deemed paid = TD/P = 400 × 300/600 = 200				
Carryback deduction allowed in third preceding year under U.S. rules:				
Reduction in profit	−1,000	0	0	
British tax refunded	0	0	+400	
Accumulated profits after tax	−400	600	1,000	
A dividend of $300 in year 4 is considered paid out of accumulated profit of year 3				$300
Tax deemed paid = TD/P = 0 × 300/1000 = 0				

Computation of U.S. Tax and Credit

	British Rules	U.S. Rules
Net dividend	$ 300	$ 300
Tax deemed paid	+200	+0
Grossed-up dividend	500	300
Gross U.S. tax (48%)	240	144
Credit	−200	−0
Net U.S. tax	40	144

In Example 3 the dividend is "sourced" under U.S. rules to year 3, where there is no tax to claim as a credit, while the $400 tax paid in year 1 can never be recovered

as a credit because no dividend can ever be "sourced" to that year. Despite the obvious distortion, the Government argues that this is the correct rule.

A problem like Example 3 can arise (and does in the present case) out of other deductions and income differences as well. Suppose the foreign corporation buys tire molds that are depreciated at the rate of 50% in the year of purchase and 50% the next year, as in Exhibits M-R (J.A. at 32-59), while U.S. rules would require depreciation over three years. The comparative calculations, using hypothetical numbers, will be as follows:

Example 4

Using British Rules:

Year		1		2		3
Profit before accounting for molds		$ 1,000		$ 1,000		$ 1,000
Deduction for molds (British rules)		−150		−150		0
British tax		−340		−340		−400
Accumulated profits after tax		510		510		600
Dividend		300		300		300
Tax deemed paid = TD/P	$\frac{340 \times 300}{510}$ =	200	$\frac{340 \times 300}{510}$ =	200	$\frac{400 \times 300}{600}$ =	200
Grossed-up dividend		500		500		500
Gross U.S. tax on dividend (48%)		240		240		240
Credit		−200		−200		−200
Net U.S. tax		40		40		40
Net U.S. tax rate on gross dividend		8%		8%		8%

Using U.S. Rules:

Year		1		2		3
Profit before accounting for molds		$ 1,000		$ 1,000		$ 1,000
Deduction for molds (U.S. rules)........		−100		−100		−100
British tax		−340		−340		−400
Accumulated profits after tax		560		560		500
Dividend		300		300		300
Tax deemed paid = TD/P	$\frac{340 \times 300}{560}$	= 182.14	$\frac{340 \times 300}{560}$	= 182.14	$\frac{400 \times 300}{500}$ =	240
Grossed-up dividend		482.14		482.14		540
Gross U.S. tax on dividend (48%)		231.43		231.43		259.20
Credit		−182.14		−182.14		−240.00
Net U.S. tax		49.29		49.29		19.20
Allowed foreign tax rate on gross dividend		37.8%		37.8%		44.4%
Net U.S. tax rate on gross dividend		10.2%		10.2%		3.5%

In Example 4 where the actual amount of British tax paid (T) is fixed for each year under British rules, as it must be, but the "accumulated profit after tax" (P) is recomputed under U.S. rules, as the Government says it should be, we see that

—The British statutory tax rate is the same in all three years (40%);

—But the British rate allowed by U.S. rules is 37.8% of the grossed-up dividend in the first two years and 44.4% in the last.

—The actual dividend paid is the same in all three years ($300);

—But the net U.S. tax in the first two years is more than 10% of the income under U.S. rules and in the last year is less than 4%.

Something must be wrong. What is it? We think the answer is plain. If we compare the *actual* British tax in dollars with profit recomputed under U.S. rules, we generate a synthetic tax rate in no way related to reality. This is why in the fraction TD/P both T and P must be computed under the same set of rules. Whenever there

is a difference in the computation of the profit, the foreign tax, or the portion of a dividend sourced to a year depending on whether U.S. or foreign law is applied, distortion and potential double taxation result because the *amount* of the British tax is 40% of the *amount* of gains, profit or income *as computed by the British.*

Exhibits I and J to the Stipulation show the end result of the opposing parties' arguments as applied to the actual facts of the present case. The *actual* foreign tax assessed for each year and the amount on which the United Kingdom imposed its tax rate were as follows (Ex. I, J.A. at 30) (all amounts being shown in pounds sterling):

	Tax	U.K. Income	Effective Rate
1968........	£1,752,096	£3,947,459	44.4%
1969........	833,251	1,932,178	43.1%
1970........	758,437	1,866,923	40.6%
1971........	-0-	-0-	N/A
Total	£3,343,784	£7,746,560	43.2%

The deviation in the effective rates from 40% merely reflects the Irish income and tax.

We may compare the above average effective tax rate percentages with those produced under the competing theories of Goodyear and the Government as shown on Exhibits I and J (J.A. at 30-31):

	Goodyear 1970	Goodyear 1971	U.S. 1970	U.S. 1971
Net dividend paid....	£ 946,521	£ 729,289	£ 946,521	£729,289
Tax deemed paid	+642,449	+586,961	+235,038	+12,086
Grossed-up dividend	1,588,970	1,316,250	1,181,559	741,375
Ratio of British tax deemed paid to grossed-up dividend	40.4%	44.6%	19.9%	1.6%

The effective rates resulting from application of Goodyear's theory are fairly close to the actual British rates and produce a credit fairly close to what was intended by the Treaty and the Code and to the credit

that would have been allowed for a branch operation. But surely when the British and the Irish actually were taxing Goodyear England at an effective rate of over 40%, the allowance of credits based on assumed foreign rates of 19.9% and 1.6% is not the way to avoid double taxation. The Government's method of sourcing moves income from one pigeonhole to another without moving the tax imposed with respect to it.

The foregoing discussion and examples make it plain, we think, that *if "accumulated profits" is computed under U.S. rules, whatever differences result will be in derogation of the basic purpose of the formula set out in section 902(a) of the Code.* And the Government has never really attempted to defend this distortion, merely implying that it is the unfortunate effect of the statute. But is it?

D. "Accumulated profits" cannot be held to mean "earnings and profits."

1. Section 902 does not support such a conclusion. The Government, in arguing on page 20 of its brief that "accumulated profits" and "earnings and profits" are synonymous terms quotes from section 902(a)(1) language which it argues "must be read in the same way" as language quoted from the definition of a dividend in section 316. But both of the quotations are incomplete, and the complete language of the two sections proves exactly the opposite.

Section 316(a) provides that

> *For purposes of this subtitle, the term "dividend" means any* distribution of property *made by a corporation to its shareholders —*
>
> (1) Out of its earnings and profits *accumulated after February 28, 1913, or*
>
> (2) *Out of its earnings and profits of the taxable year . . . .*

This statute rather clearly means that if a distribution is *not* out of earnings and profits, it is not a dividend, a generally accepted conclusion.

Section 902(a)(1) on the other hand begins

(1) *to the extent such* dividends *are* paid *by such foreign corporation* out of accumulated profits . . . .

The language of the two sections (with the italicized omissions restored) clearly contemplates that there can be a distribution of *earnings and profits* (a dividend) which is *not* out of *accumulated profits*. The omission in the Government's brief of "to the extent such" in section 902(a)(1) and of "the term dividend means any" from section 316(a) obscures the contrast between "earnings and profits" and "accumulated profits." There is no escaping the conclusion: "earnings and profits" and "accumulated profits" are two different things.

Moreover, the term "earnings and profits" was used elsewhere in the tax law before the Revenue Act of 1918, Pub. L. No. 65-254, § 240(c), 40 Stat. 1082, introduced the indirect tax credit. So why did Congress not use it instead of "taxable profit" and "accumulated profit?" *See infra* p. 30 for a discussion of the Revenue Act of 1918. Might it not have been because "earnings and profits" measured the *U.S.* income of the parent that received a dividend, and Congress wanted to use a different term to refer to the foreign income base on which the foreign tax was imposed?

Furthermore, whether "accumulated profits" refers to British taxable income or U.S. taxable income, it unquestionably refers to income *on which* a tax is imposed, *not* "earnings and profits."

2. "Earnings and profits" is not an available alternative under the Stipulation in this case. In any event the Government's case here, under the Stipulation, is that "accumulated profits" means income computed as it would be for a U.S. taxpayer; there is no room here for an argument that it is "earnings and profits." This point has already been discussed at page 5 above.

3. Congress itself in 1986 used the terms "accumulated profits" and "earnings and profits" in the same statute with contrasting meanings. In the Tax Reform Act of 1986, the new Code section 902, which effectively replaced the section involved in the present case, adopted the position argued unsuccessfully for the taxpayer in *General Foods Corp. v. Commissioner*, 4 T.C. 209 (1944), *acq.* 1946 C.B. 2 (discussed *supra* pp. 16-18), that the accumulated profits and the foreign tax are to be taken in the aggregate — that the tax deemed paid is that proportion of the aggregate which the dividend bears to the aggregate undistributed "earnings and profits." The Act of 1986 eliminates the "pigeonhole" method of "sourcing" for the future since year-to-year distortions will now be eliminated by averaging so that whether future "accumulated profits" are computed under foreign or U.S. law will no longer be important. But the term "accumulated profits" is nevertheless retained for computation of the credit on dividends out of *pre-1987* undistributed earnings.

Why, in the Act of 1986, did Congress use "accumulated profits" in the provision applicable *before* 1987 and "earnings and profits" in the provision applicable *after* 1986 if the two phrases were synonymous? Apparently because they were not.

E. The statutory definition of "accumulated profits" in section 902(c) clearly provides that "accumulated profits" refers to the foreign tax base.

Subsection 902(c)(1)(A) provides:

(c) Applicable Rules —

(1) Accumulated Profits Defined. — For purposes of this section, the term *"accumulated profits" means* with respect to any foreign corporation —

(A) . . . . the amount of its *gains, profits, or income* computed without reduction by the amount of the income, war profits, and excess profit taxes *imposed on or with respect to such profits or income* by any foreign country or any possession of the United States; . . . [emphasis supplied]

This clearly says that the amount of the accumulated profits equals the amount of the gains, profits or income on which the foreign tax was imposed. If "gains, profits or income" does not refer to the foreign tax base, then Britain is applying its tax rate to U.S. "taxable income."

In a predecessor of section 902, section 240(c) of the Revenue Act of 1918, Congress used the term "taxable income" of the foreign subsidiary to refer to the denominator of the deemed paid credit fraction (P). Taxable by whom? That income is not taxable in the U.S. "Taxable income" *must* refer to income taxable by the foreign country. Such income is of course measured by the foreign taxing authority just as the "taxable income" of a U.S. taxpayer is measured in U.S. terms. *United Dyewood Corp. v. Bowers*, 44 F.2d 399 (S.D.N.Y. 1930), *aff'd per curiam*, 56 F.2d 603 (2d Cir. 1932). Although section 238(e) of the Revenue Act of 1921, Pub. L. No. 67-98, 42 Stat. 259, replaced the term "taxable income" with the term "accumulated profits," nothing in the legislative history of the Revenue Act of 1921 suggests that Congress intended to switch to a U.S. tax concept when it substituted the term "accumulated profits" for "taxable income."

F. The opinion of this Court in *American Chicle Co. v. United States* implies that "accumulated profits" means the foreign tax base.

Did Congress mean by this change in the formula from "taxable income" in the Act of 1918 to "accumulated profits" in the Act of 1921 to change the meaning from the tax base of the foreign country to a simulated U.S. tax base in the formula?

Apparently not in the view of this Court when it drafted its opinion in *American Chicle Co. v. United States*, 316 U.S. 450 (1942), where it said the subsidiary's accumulated profits are its "total taxable profits less taxes paid." *Id.* at 452. Thus "accumulated profits" apparently still refers to the foreign tax base.

G. The Treasury Regulations do not dictate a contrary result.

The Regulations in effect for the years 1970 through 1975 were those that were adopted in 1965 to apply to the Revenue Act of 1962, which introduced "grossing up." References to the Regulations in this brief will refer to those Regulations, except where otherwise indicated.

Treas. Reg. § 1.902-3(a)(2) sets out the formula for computing the credit essentially in the words of the statute, giving credit for the foreign tax paid "on or with respect to" the accumulated profits in the proportion that the dividend bears to the same accumulated profits. So far, the Regulation paraphrases the statute.

The same Regulation goes on to say, in § 1.902-3(c)(4):

> Since . . . *the accumulated profits*, determined in accordance with subparagraph (1) of this paragraph, for the taxable year *are always equal to the total amount of the gains, profits, and income* for such year, the foreign income taxes imposed on or with respect to such accumulated profits shall be the entire amount of the foreign income taxes paid or accrued for such year *on or with respect to* such gains, profits, and income. [Emphasis supplied]

And in Example (2) in Treas. Reg. § 1.902-5(e) a foreign rate of 40% is applied to "gains, profits and income" of $100 to produce a foreign tax of $40, clearly confirming that "gains, profits and income" is the base on which the foreign government computes its tax.

Treas. Reg. § 1.902-3(c)(1) on the other hand provides that the "accumulated profits" is the sum of the "earnings and profits" of the taxable year and the foreign taxes imposed on the "gains, profits and income" to which the "earnings and profits" are attributable. This reference to "earnings and profits" appears for the first time in the Regulations in 1965 and appears only in the part of the Regulations applicable to post-1965 distribu-

tions. Does this reflect a change in the law? It would appear not as there is no change in the Revenue Act of 1962 in this respect.

We think the purpose of the isolated reference to "earnings and profits" in Treas. Reg. § 1.902-3(c)(1) was to deal with a situation in which the "gains, profits and income" after tax (foreign rule) exceeded the aggregate "earnings and profits." Since section 902 is explicitly limited to cases where a dividend has been received by the parent and since a distribution in excess of aggregate "earnings and profits" is not a dividend, there must be excluded from P the amount of the non-dividend distribution. The Regulation does *not* purport to say that where there is a dividend it is to be "sourced" under U.S. rules.

Let us look at this language with some specific figures in mind. Let us suppose that the foreign corporation has "gains, profits and income" (the foreign tax base) of $1,000 and pays a tax of $400, leaving $600. Let us suppose further that the "earnings and profits" (the amount that determines what portion of a distribution is a dividend and what portion is a return of capital) is $500. Finally let us suppose a distribution of $1,500.

The distribution in question is a "dividend" — taxable to the U.S. recipient — to the extent of the earnings and profits, which is $500. This is so regardless of the amount of "gains, profits and income" the British recognized.

The "accumulated profits" after tax, according to Goodyear's theory, were $600. But the section 902 credit is available only to the extent that there is a dividend, in this case $500, the amount of the earnings and profits. D in the formula is therefore $500.

When we look at the rest of paragraph (c)(1) of the Regulation, however, we see that we are to add to the $500 the taxes imposed on the gains, profits and income to which the earnings and profits are attributable, not the entire amount of the taxes on the entire

$600 of accumulated profit after tax, but the taxes attributable to the $500 portion of the $600 distribution that constituted a dividend. This appears to be the problem dealt with in Treas. Reg. § 1.902-3(c)(1). It is not relevant to the present case, in which the entire amount of each distribution in question is conceded to be a taxable dividend.

All of this is consistent with section 902(c)(1), quoted above. As the Claims Court concluded in its opinion:

> The relation of "gains, profits and income" to foreign income taxes indicates this tax concept *is to be equated with foreign taxable income.* [Emphasis supplied] [Cert. App. at 26a]

And the Court of Appeals reached the same conclusion, saying:

> These provisions establish that "P" *is the actual basis on which the foreign sovereign assesses tax liability.* Because "T" is the actual tax imposed by the foreign government, "P" must also be the basis to which the foreign government applies its own tax law in computing "T". Rev. Rul. 74-310, 1974-2 C.B. 205 (foreign income tax to be used in section 902 computation is amount of tax imposed on total profits as measured by foreign standards). For this reason, *we find the plain meaning of the statute requires "P" to be determined under foreign law.* [Emphasis supplied] [Cert. App. at 6a]

The conclusion seems indisputable: in "sourcing" the income of a foreign corporation, "accumulated profits" means "gains, profits or income" and "gains, profits or income" means foreign taxable income. Therefore, "accumulated profits" means foreign taxable income, not income recomputed as if the foreign corporation had been a U.S. taxpayer.

H. The line of decisions with respect to the section 902 credit hold or suggest that "accumulated profits" relates to the foreign tax base.

In examining the cases it is important to distinguish cases dealing with aggregate "earnings and profits" — essentially the corporate surplus available for the payment of dividends — from those dealing with the "accumulated profits in excess of tax," the term used in sourcing the dividend. The first determines whether a distribution represents taxable income to the recipient or a return of capital. That is a U.S. tax question, involving as it does the taxability of an amount received by a U.S. taxpayer. The second involves the attempt to determine what foreign tax was imposed with respect to what income, which is the problem in this case — the problem of sourcing.

1. ***United Dyewood Corp. v. Bowers.*** This case clearly demonstrates that in the 1918 Act "taxable income" meant the foreign tax base. The Second Circuit said, ". . . the words, 'the total taxable income . . . upon . . . which such taxes were paid,' mean the sum used by the foreign government as a base to compute the foreign tax." *United Dyewood Corp. v. Bowers*, 56 F.2d 603, 603 (2d Cir. 1932).

2. ***American Chicle Co. v. United States.*** This Court's decision in *American Chicle Co. v. United States*, 316 U.S. 450 (1942), equates "accumulated profits" with "taxable profits" and with "taxable income" in the Revenue Act of 1918 and fairly clearly implies that the term refers to the foreign tax base. While the statement may not have been critical to the *American Chicle* decision, which did not involve sourcing, it seems to have been carefully considered by this Court.

3. **The "sourcing" cases.** Only three other cases bear, to a greater or lesser degree, on the determination of the numbers to be used in the formula TD/P: *Pacific Gamble Robinson Co. v. United States*, 62-1 U.S.T.C. ¶ 9160 (W.D. Wash. 1961) (not officially reported); *H.H. Robertson Co. v. Commissioner*, 59 T.C. 53 (1972), *aff'd mem.*, 500 F.2d 1399 (3d Cir. 1974); and *Champion International Corp. v. Commissioner*, 81 T.C. 424 (1983),

acq. 1984-2 C.B. 1, *acq. partly withdrawn* Rev. Rul. 87-72, 1987-2 C.B. 170.

Pacific Gamble Robinson Co. v. United States is contrary to the position of Goodyear, but in *Champion International Corp. v. Commissioner* the Tax Court specifically refused to follow it. 81 T.C. at 443 n.29.

H.H. Robertson Co. v. Commissioner involved *both* the section 312 problem of inclusion of a dividend in the parent's income and the section 902 problem of sourcing. The court began its discussion of the sourcing issue by pointing out that:

> [T]he term "accumulated profits" as used in section 902 refers to a concept *that is quite different from, although related to*, the meaning of the more familiar and widely used term "earnings and profits." [59 T.C. at 75] [Emphasis supplied]

In *Champion International Corp. v. Commissioner* the taxpayer's Canadian subsidiary had had a net operating loss for 1970, which under Canadian law was allowable as a deduction for 1969, producing a refund for that year. Under U.S. law a loss in 1970 would have been allowed as a deduction in 1968. The Government recognized the refund as reducing T in the formula for 1969 and the loss as reducing the amount available as a dividend for that year (D in the formula) but refused to recognize the loss as reducing the accumulated profits after tax (P in the formula). The Tax Court made clear the distinction between "earnings and profits" as the significant number in determining whether a distribution is a dividend and "accumulated profits," which is the significant number in solving the "sourcing" problem. 81 T.C. at 431-32.

The court went on to hold that the loss must be applied in determining *both* P and D, thus following the Canadian computation, saying:

> The purpose of U.S. tax principles in the context of section 902 is to establish a correlation

between the foreign taxes paid on the foreign subsidiary's accumulated profits of a particular year and the dividends paid from the same year's accumulated profits. *To ignore the fact that foreign law computes the tax liability by allowing for loss carrybacks is to assure that this correlation will be lost.*

Petitioner's resolution of this problem does not conflict in any fundamental way with U.S. earnings and profits criteria; it merely reconciles those criteria with the principle that "it is necessary to relate the tax credit to the particular year or years in which the accumulated profits (from which the dividends were paid) were earned and taxed." *General Foods Corp. v. Commissioner*, 4 T.C. at 216. That reconciliation is then applied consistently throughout the section 902(a)(1) computation, in the denominator as well as in the numerator of the fraction. Only in this way can the purpose of the section 901 credit be achieved and the language of section 902(a)(1) followed. [81 T.C. at 440] [Emphasis supplied]

On the Commissioner's alternative argument, which would have applied the loss *neither* to the numerator nor the denominator (the result the Government urges in the present case), the Court added:

In suggesting that the foreign taxes be reduced to reflect the refund occasioned by the carryback, while the dividends and accumulated profits remain unaffected by the carryback, respondent has proposed a formula whose terms do not stand in the coherent relationship provided for in the statute. The foreign taxes under that formula are not those which were paid "on or with respect to such accumulated profits," *because the taxes have been changed to reflect the carryback while the accumulated profits have not.* [81 T.C. at 443] [Emphasis supplied]

This is Goodyear's complaint exactly. Here, too, the taxes for 1970 and 1971 "have been changed to reflect the carrybacks while the accumulated profits have not."

In discussing the Government's argument in *Champion*, the Tax Court said:

Respondent frankly admits that his position "will under some limited circumstances result in double taxation," the avoidance of which, he concedes, is the "fundamental purpose of the foreign tax credit provisions." [81 T.C. at 436 n.19]

4. The section 312 cases are not relevant to this issue. Cases involving the amount to be included in the income of the parent (the section 312 problem) include such cases as *Steel Improvement & Forge Co. v. Commissioner*, 36 T.C. 265 (1961), *rev'd*, 314 F.2d 96 (6th Cir. 1963), and *Untermeyer v. Commissioner*, 24 B.T.A. 906 (1931), *aff'd*, 59 F.2d 1004 (2d Cir.), *cert. denied*, 287 U.S. 647 (1932). Neither case involved the present problem. Both dealt with "earnings and profits."

It is essential to recognize that these cases, like section 312 and the other statutory provisions discussed above, are concerned with the amount to be included in the income of the *domestic* taxpayer. They do not deal with sourcing, which is the problem of pairing the income of the foreign subsidiary with the tax imposed on it.

I. The Code provisions that require application of U.S. rules expressly so specify, and deal exclusively with the inclusion of income of foreign subsidiaries in the income of U.S. corporate taxpayers.

In various situations in which income of a foreign taxpayer is included *as such* in the income of a U.S. taxpayer, U.S. rules are *specifically* invoked. The following sections of the Code require the direct inclusion of foreign income in the taxable income of a domestic taxpayer. All of them, as would be expected, provide that United States rules apply to the computation of the

income of the U.S. taxpayer notwithstanding the fact that it was earned in a foreign country:

Section 555 (foreign personal holding company income);

Sections 951 and 964 (subpart F income);

Section 1246 (gain on sale of stock in foreign investment company); and

Section 1248 (sales or exchanges of stock in a foreign corporation).

But the problem of "sourcing" a dividend from a foreign corporation is not a matter of determining the amount of income included by a United States taxpayer. Sourcing is governed by section 902, which in contrast to the above section *has no provision* calling for the application of United States rules, instead defining "accumulated profits" in terms of the foreign income tax base. And it should be noted that even in the sections above the reference (except in section 1248) is to "income" by U.S. rules, not to "earnings and profits."

II. The Government's argument.

A. The Government's argument that "accumulated profits" is an aggregate term would result in judgment for Goodyear.

If the formula for determining the foreign tax deemed paid is applied using the aggregate past taxes paid by Goodyear England and the aggregate profits of prior years as T and P, respectively, it will result in the allowance of most of Goodyear's refund claim. *See* discussion *supra* pp. 6-7.

B. The argument that recomputing the foreign gains, profits and income on which the foreign tax was imposed as if the foreign corporation were a U.S. taxpayer is more likely to produce a correct foreign tax credit is demonstrably contrary to fact.

This argument has been mentioned above and its error demonstrated by examples such as Example 2 at

pages 21-22. If a dividend in an agreed amount is sourced to the years when the British taxed the profit from which it was paid, it will be paired with British taxes; if it is sourced anywhere else, it will not be paired with the British taxes, some of which may never be credited.

In Goodyear's case real dividends have been charged against income constructed in several years by the Government when no such income was recognized and taxed by the British. Yet the amount of such dividends reduces the "earnings and profits" available for future dividends. When the "earnings and profits" are thus eliminated, future distributions will not be dividends and no credit will be allowed for taxes actually paid. *Any* such readjustment of foreign gains, profits and income results in distortion that reduces or eliminates the credit properly allowable.

On the other hand it is clear that Goodyear's view can in no event result in tax credits in excess of the total taxes not yet so credited or otherwise recovered.

C. The examples in the Government's brief use artificially distorted numbers and in fact disprove what they seek to prove.

Goodyear's argument and that of the Court of Appeals opinion have rested on the necessity for consistency between foreign tax and the foreign tax base in computing the credit. It is respectfully submitted that the examples worked out in Goodyear's brief prove the point, and we have challenged the Government to produce similar examples to support its side. It has not seen fit to do so. It has set forth on pages 21 and 22 and again on page 31 of its brief what purports to be an example but has not set out the figures in any kind of schedule. It may be helpful to show the assumed numbers in the three cases set out (all except the apparent foreign tax rate being from the Government brief) as follows:

	U.S. Rules	Foreign Rules
Case 1		
Earnings	100	100
Foreign tax	20	20
Apparent foreign tax rate		20%
Case 2		
Earnings	100	180
Foreign tax	20	20
Apparent foreign tax rate		11.11%
Case 3		
Earnings	100	60
Foreign tax	20	20
Apparent foreign tax rate		33.33%

The Government then argues that using the foreign tax base as the measure of accumulated profits produces "eccentric results." If we allow as a premise that the British compute their tax by applying their rate to *U.S. income* then of course the British tax will bear no consistent relationship to the British tax base. But that assumption is contrary to fact. The British tax is computed by applying the British rate to the British tax base and is necessarily consistent with it. This example proves only that if eccentric data are fed into a formula, it will produce eccentric results.

If the Government had seen fit to use a *constant* foreign rate of tax in its example and to lay out for the Court's examination comparative schedules, as Goodyear has done, showing the differing results reached by application of U.S. rules as opposed to following the foreign determination, the examples would inevitably demonstrate the same conclusion reached by Goodyear in its similar examples. That conclusion is that since the foreign tax represents the foreign tax rate applied to the foreign tax base, any attempt to substitute for the foreign tax base in the denominator an amount based on income redetermined according to U.S. law will distort the credit and defeat the statutory purpose.

D. The argument that sections 902 and 316 together prove that "accumulated profits" and "earnings and profits" are the same thing is based on incomplete quotation of the law.

This point has been discussed at pages 27-28 of the present brief. All dividends are distributed out of earnings and profits. *Not* all dividends are paid out of accumulated profits. But, *to the extent* that they are, they are sourced to the accumulated profits of each year as determined by the foreign taxing authority to determine the foreign tax "appropriate" to them.

In any event, as demonstrated above at page 5, the stipulated issue here is between foreign "gains, profits and income" and "taxable income" under U.S. rules; "earnings and profits" are not the issue, and have not been set out in the Stipulation at all.

E. The decision below did not overturn any established administrative practice.

In attributing such an effect to the decision, the Government relies on these rulings:

I.T. 2676, XII-1 C.B. 48 (1933). The language quoted by the Government at page 32 of its brief merely requires that all income be included in the tax credit computation, whether or not the income is taxed by the foreign country, but it does not say that computations such as the amount and timing of income, depreciation, and inventory adjustments are to be taken into account as if U.S. rules applied; in fact the ruling talks about the "distributable income or surplus" of the foreign corporation, and suggests, if anything, a corporate surplus such as British accountants would determine. The ruling clearly fails to establish a practice of applying U.S. tax principles in "sourcing" a dividend. In fact the principles of sourcing and grossing up were not established for another ten years.

In any event, this ruling was declared obsolete by Rev. Rul. 70-293, 1970-1 C.B. 282.

Rev. Rul. 63-6, 1963-1 C.B. 126. This ruling does indeed assert that U.S. rules should govern the determination of "accumulated profits." But in 1972 the Commissioner declared this ruling too to be obsolete. Rev. Rul. 72-621, 1972-2 C.B. 651.

Rev. Rul. 87-72, 1987-2 C.B. 170. This ruling partially withdrew the Commissioner's announced acquiescence in the *Champion* case, which essentially supports Goodyear's argument. In 1984 the Commissioner had announced his general acquiescence in *Champion.* But in September 1985 Goodyear filed the present action in the Claims Court, and in April 1987 it filed its Motion for Summary Judgment. Then on August 3, 1987 the Commissioner issued Rev. Rul. 87-72, which appears to be an attempt to limit his acquiescence in *Champion* so as to leave room for his contrary position in the present case. This action by the Commissioner merely confirms the fact that the *Champion* case really supports Goodyear.

Rev. Rul. 87-14, 1987-1 C.B. 181. This ruling, issued while the present case was pending (and after the Tax Reform Act of 1986 had eliminated "sourcing" for future years), is similarly self-serving.

One point does seem clear: the Commissioner's position when he withdrew his 1963 ruling and when he acquiesced in the *Champion* case was contrary to his later position when he issued Rev. Rul. 87-72 and withdrew the acquiescence in *Champion.* Moreover, one other ruling, Rev. Rul. 74-310, 1974-2 C.B. 205, is inconsistent with the rulings cited above because it holds that:

> the amount of foreign income tax paid by a domestic corporation's wholly owned subsidiary that uses the completed contract method of accounting for Federal income tax purposes but uses the percentage of completion method for foreign income tax purposes is determined by foreign standards.

The text of the ruling quoted the very definition of "accumulated profits" in Reg. § 1.902-3(c)(4) on which Goodyear relies.

Although the Government asserts that the Commissioner's position is fifty years old, the whole concept of sourcing was not established until the *General Foods* case in 1944. The language of the Regulations under Section 902 on which the Government relies was not a part of the Regulations until 1965. Furthermore, the Government's quotation on page 33 of its brief from Treas. Reg. § 1.902-3(c) is not quite complete. The omitted portion goes on to say:

> Since . . . *the accumulated profits*, determined in accordance with subparagraph (1) of this paragraph, for the taxable year *are always equal to the total amount of the gains, profits, and income for such year*, the foreign income taxes imposed on or with respect to such accumulated profits shall be the entire amount of the foreign income taxes paid or accrued for such year on or with respect to such gains, profits, and income. [Treas. Reg. § 1.902-3(c)(4)] [Emphasis supplied]

Thus in 1965, *only five years* before the first dividend involved in the present case, a new Regulation essentially supported Goodyear's position. This language still appears in the Regulation. This is hardly fifty years of consistency.

Finally, perhaps it is not unfair to point out that in the present case a similar net operating loss of the very same British subsidiary for 1972 was allowed by the Internal Revenue Service in computing the Respondent's foreign tax credit in this case. *See supra* note 3.

III. The opinion of the Claims Court.

While some aspects of the opinion of the Claims Court have already been discussed, some further points should be mentioned here.

A. Factual misconceptions.

1. Referring to the 1970 and 1971 dividends, the Claims Court incorrectly stated (Cert. App. at 10a) that Goodyear claimed credit for British tax deemed paid *on*

the dividends. Britain did impose a tax on those dividends and the credit claimed for *that* tax was allowed as a *direct* tax credit. That tax is not involved in the present case. The credit claimed here is for the British tax imposed on the profits of Goodyear England for 1968, 1969, 1970 and 1971, *out of which* the 1970 and 1971 dividends were paid (Ex. I, J.A. at 30).

2. The Claims Court said the 1972 loss was "recognized under both United States and British tax law." This is not the fact and does not appear in the Stipulation. Exhibits I and J (J.A. at 30-31) show that the income for 1971 *after* the 1972 carryback was £1,648,254. The British tax return for 1971 (Exhibit P, J.A. at 46-49) shows that the income reported thereon of £1,648,254 was the result of subtracting the 1972 loss from the income as computed for British purposes. The 1972 loss, as shown on Exhibit P, was £1,397,828, which is the same amount shown on the British return as filed for 1972 (Exhibit Q, J.A. at 50-53). In its recitation of the facts of the case, the Claims Court implied that the circumstances giving rise to the deduction in 1973 were different from those giving rise to the 1972 deduction. *See* Cert. App. at 10a-11a. The court's statement is not in accordance with the Stipulation.

3. The Claims Court said that "Both parties in the present case agree that United States tax law governs the definition of the numerator, that is, whether a distribution of property by a foreign subsidiary to a domestic parent corporation is a dividend or a return of capital." Cert. App. at 20a-21a. Goodyear did not agree with that sentence. Goodyear does agree, although it is not at issue here, that whether a distribution of property by a foreign subsidiary to a domestic parent corporation is a dividend or a return of capital for U.S. income purposes is governed by U.S. law. That is what the *Steel Improvement & Forge* case was about. But to turn that statement into a statement that U.S. tax law governs the definition of the numerator in the section 902 fraction is

to demonstrate the complete misunderstanding under which the Claims Court was laboring.

4. The Claims Court said, "The parties have stipulated that all adjustments made by the Commissioner were proper under United States tax law and that the two British deductions which resulted in the 1973 loss were not allowable deductions under United States tax law." Cert. App. at 24a. This is not in the Stipulation. Goodyear agreed in paragraph 9 of the Stipulation (J.A. at 22-23) that the deductions in question would not have been allowed if Goodyear England had been a U.S. corporation. But it was *not* a U.S. corporation and was *not* subject to U.S. tax. It filed its return in England, which allowed the deductions in computing the foreign taxes in question.

B. Tax avoidance charge.

The Claims Court apparently thought Goodyear was asserting a claim for credit for taxes that had been refunded and accused Goodyear of attempting to "eviscerate the very purpose of the pro-rata credit and permit plaintiff a substantial windfall in avoiding other taxes with the phantom taxes deemed paid." Cert. App. at 24a.

If this were a fair description of Goodyear's argument, the pejorative language might be deserved. But the Claims Court apparently failed altogether to grasp the concept of "sourcing." Goodyear is not asserting a claim to the 1970 and 1971 taxes that were refunded. Goodyear is claiming that because there was a loss in 1973 which carried back to 1971 and to 1970, accumulated profits for those years were reduced or eliminated, and it was this event that produced the refund. There being no accumulated profits in 1971 and an insufficient amount in 1970, some of the dividends must be sourced to 1969 and 1970, and it is the taxes paid to Britain for *those* years which are claimed as credits. They are most certainly *not* "phantom taxes."

C. "Gains, profits and income."

The Claims Court clearly said that:

The relation of *"gains, profits and income" to foreign income taxes indicates this tax concept is to be equated with foreign taxable income.* [Cert. App. at 26a] [Emphasis supplied]

That court also quoted the provision of section 902(c)(1)(A) defining "accumulated profits" as equal to "gains, profits or income." Cert. App. at 19a-20a. It would seem to follow that "accumulated profits" equals foreign taxable income. Then how can we explain the Claims Court's assertion that the denominator of the fraction, which is "accumulated profits," means U.S. income?

We think the answer is that the Claims Court mistakenly thought the parties had agreed that U.S. law governed the numerator; thus it was forced to hold that algebraic consistency required that the denominator be determined under U.S. law, notwithstanding its analysis above, which seems to lead to the opposite conclusion. But the parties did not so agree.

Actually in the present case the dividends were in cash, which has the same value in either country. On the other hand T — the tax — is part of the numerator, and the tax is necessarily determined under British law. Algebraic consistency would therefore require that the denominator be computed the same way. And that way, not coincidentally, corresponds not only with the words of the statute but with its purpose of producing a result harmonious with the direct tax credit and with common sense.

In view of these clear errors on the face of the Claims Court's opinion, it should be evident that the Court of Appeals had no choice but to reverse its judgment.

IV. Policy considerations.

Even if it had not appeared quite so clearly that the Court of Appeals was correct in its understanding of the law, this Court should resolve any doubts in favor of Goodyear for the following reasons:

A. Goodyear's computation necessarily produces a fairer result.

Since it is clear that in no event may there be a credit for more foreign tax paid than was actually paid and not recovered as a credit or as a refund, it must follow that the computation that produces the greater credit must necessarily approach most closely the result applicable to a branch operation, which always produces a full recovery, subject only to the limits of section 904.

B. Attempting to redetermine income of foreign corporations as if they were U.S. taxpayers will create endless administrative problems.

In its petition for certiorari, the Government argued that a decision for Goodyear would impose an unreasonable administrative burden on the Internal Revenue Service. The contrary is true. A decision for the Government will greatly burden both the Internal Revenue Service and corporate taxpayers seeking to obtain the credit in a number of ways. For example:

1. Will the U.S. agent make an audit of the foreign corporation to determine whether its foreign return satisfies U.S. rules?

2. Can the U.S. agent second-guess the foreign agent on whether items claimed as repair expense should be capitalized?

3. Will charitable contributions by foreign corporations have to satisfy U.S. standards by having foreign charitable donees qualify under section 501(c)(3), as is required in the U.S.?

4. Will the U.S. agent, applying U.S. rules, require that contributions to pension and profit sharing plans be

made to plans qualified under the U.S. Internal Revenue Code?

5. What about inventory pricing rules? That issue is actually present in the case at bar. And the Internal Revenue Service decided in 1982 to begin requiring foreign corporations to apply to it for permission to adopt the "Last-in-First-out" method of pricing inventories. Private Letter Ruling 8313083 (Dec. 28, 1982). Less than a year and a half later, perhaps recognizing the anomaly of attempting to regulate the accounting practices of a corporation which was not a U.S. taxpayer at all, the Internal Revenue Service amended its ruling to require that the U.S. corporate shareholder claiming the foreign tax credit should apply to the Internal Revenue Service for permission to have the foreign corporation use the changed accounting method to compute the credit under section 902. Private Letter Ruling 8435119 (May 31, 1984). It did not allude to the possibility that the foreign corporation might have more than one U.S. corporate shareholder qualifying for the section 902 credit nor to the rule of Treas. Reg. § 1.472-1 that LIFO accounting may be elected for tax purposes only if it is also regularly employed for corporate accounting purposes.

6. How will these adjustments be contested? The foreign corporation cannot do so because its own taxes are not at issue; it cannot appear as a party to a suit in a U.S. court on these matters.

7. Section 902 allows the indirect credit to any corporation owning 10% or more of a foreign corporation. Can each of them contest all of these issues separately?

8. The fact is that those who drafted the foreign tax credit provisions apparently did not contemplate that there would be any such issues to contest. Section 905 provides that in the case of a refund of a foreign tax (as in the present case) the credit allowed the U.S. corporation shall be redetermined *and assessed*. There is no

provision for a statutory Notice of Deficiency under section 6212, which is the condition precedent to filing a case in the Tax Court, and none was issued in the present case. Obviously no provision for appeal to the Tax Court was thought necessary because no disputes were anticipated. If the Government is correct, Congress will have to establish procedures for resolving the anticipated disputes.

All these issues and more — in fact everything that can give rise to litigation under Internal Revenue Code provisions applicable to U.S. corporate taxpayers — can be reaudited if U.S. law is to be applied. Yet none of this actually affects the income tax liability of the foreign corporation to its government or to ours. It bears only on the sourcing of the profits to various years so as to determine what tax was paid in an earlier year that can be allocated to a dividend. In most years it obviously will not even matter, but the audit must be made to find out whether it does matter. Minds will be boggled that have never been boggled before. And all this for a statute that was repealed in 1986!

CONCLUSION

Neither the language nor the purpose of section 902 of the Code will be served unless the deemed paid foreign tax credit to which Goodyear is entitled is computed in a manner which relates the foreign taxes to the accumulated profits on which the taxes were imposed and from which the dividend from Goodyear England to its U.S. parent was paid. This can be accomplished only if this Court rules that it is proper to reduce Goodyear England's accumulated profits for 1970 and 1971 to reflect the application of the foreign net operating loss carryback that gave rise to the refunds.

Goodyear respectfully requests that the judgment of the Court of Appeals be affirmed.

Respectfully submitted,

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APPENDIX

The Treasury Regulations, as in effect in 1970 and 1971, provided in pertinent part:

§ 1.902-3. Credit for domestic corporate shareholder of a foreign corporation (after amendment by Revenue Act of 1962).

* * * * *

(c) *Determination of accumulated profits and taxes paid on or with respect thereto.*

* * * * *

(4) *Taxes paid on or with respect to accumulated profits of a foreign corporation.* For purposes of this section, the amount of foreign income taxes paid or accrued on or with respect to the accumulated profits of a first-tier corporation or second-tier corporation, as the case may be, for any taxable year shall be so much of the foreign income taxes for such year as is properly attributable to such accumulated profits. For such purpose, the foreign income taxes which are properly attributable to the accumulated profits for any taxable year shall be the same proportion of the foreign income taxes imposed on or with respect to the gains, profits, and income for the taxable year as the accumulated profits, as determined under the applicable provision of this paragraph, bear to the total amount of such gains, profits, and income. Since, in applying the preceding sentence to a first-tier corporation which is not a less developed country corporation for the taxable year (and to a second-tier corporation to which subparagraph (3)(i) of this paragraph applies), the accumulated profits, determined in accordance with subparagraph (1) of this paragraph, for the taxable year are always equal to the total amount of the gains, profits, and income for such year, the foreign income taxes imposed on or with respect to such accumulated profits shall be the entire amount of the foreign income taxes paid or accrued for such year on or with respect to such gains, profits, and income. For purposes

of this subparagraph, the gains, profits, and income of a foreign corporation for any taxable year shall be determined after reduction by any income, war profits, or excess profits taxes imposed on or with respect to such gains, profits, and income by the United States.